No. 12,814

IN THE

United States
Court of Appeals

FOR THE NINTH CIRCUIT

UNITED STATES OF AMERICA, Appellant
v.
P. J. LYNCH, Appellee

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v.
UNITED STATES OF AMERICA, Appellee

ON APPEALS FROM THE UNITED STATES DISTRICT COURT FOR THE EASTERN DISTRICT OF WASHINGTON

REPLY BRIEF FOR THE UNITED STATES

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It has been stipulated between the parties hereto that the appeal on each side would be covered in the opening brief of each party filed in accordance with that stipulation, and that each party would file a reply to the brief of the other side. This brief is the reply of the United States in the taxpayer's appeal.

QUESTION PRESENTED

The appeal of the taxpayer presents the question of whether or not the Commissioner of Internal Revenue erred in including as income to the Washington Fruit and Produce Company certain storage charges which had been earned during its taxable period ended April 29, 1944.

STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code:

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but * * * if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. * * *
(26 U.S.C. 1946 ed., Sec. 41.)

SEC. 42. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. * * *

* * * * *

(26 U.S.C. 1946 ed., Sec. 42.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:

Sec. 29.41-1. *Computation of Net Income.*—Net income must be computed with respect to a fixed period. Usually that period is 12 months and is known as the taxable year. Items of income and of expenditure which as gross income and deductions are elements in the computation of net income need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation, can be valued in terms of money. The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. (See sections 29.42-1 to 29.42-3, inclusive.) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it.

Sec. 29.41-2. *Bases of Computation and Changes in Accounting Methods.* — Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. * * * All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. * * *

* * * * *

Sec. 29.41-3. *Methods of Accounting.*—It is recognized that no uniform method of accounting can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose. Each taxpayer is required by law to make a return of his true income. He must, therefore, maintain such accounting records as will enable him to do so. * * *

* * * * *

Sec. 29.41-4. *Accounting Period.*—The return of a taxpayer is made and his income computed for his taxable year, which in general means his fiscal year, or the calendar year if he has not established a fiscal year. (See section 48.) The term "fiscal year" means an accounting period of 12 months ending on the last day of any month other than December. * * *

Sec. 29.42-1. *When Included in Gross Income.*—(a) *In general.*—Except as otherwise provided in section 42, gains, profits, and income are to be included in the gross income for the taxable year in which they are received by the taxpayer, unless they are included as of a different period in accordance with the approved method of accounting followed by him. * * *

* * * * *

STATEMENT

Inasmuch as the facts relating to the appeal of the United States are set forth in its opening brief, this statement will be limited to the issue raised in the taxpayer's appeal. The facts relating to that issue, as found by the court below and as adduced in evidence, may be summarized as follows:

The Washington Fruit and Produce Company, a corporation, hereinafter called the Company, was engaged in the handling, growing, marketing and warehousing of fresh fruits and vegetables. (R. 12.) The company also engaged in the business of storing fruit, meat and other products. (R. 38.) Its charges for storage were normally billed against customers at the time the stored goods were removed from its warehouse (R. 40, 93) and this was the general practice of the business in the community in which the Company operated (R. 41, 93, 111). This practice was followed because of the potential spoilage and loss of stored goods. (R. 76, 93, 114-115.) The Company endeavored to protect itself against this potential spoilage by appropriate insurance coverage. (R. 41.)

The Company kept its books (R. 44) and rendered its income tax returns (R. 124) upon the accrual basis as of June 30, the end of its fiscal year (R. 45, 88, 115). It generally accrued expenses incident to the operation of its business (R. 61, 65, 121, 133) but storage charges collectible by it were not included in income until paid (R. 59, 65-66). This practice, however, usually did not preclude correct reflection of income for the fiscal year because ordinarily most of the stored goods were removed from its warehouse and sold by or before June 30 each year in the normal operation of the Company's business. (R. 46, 88-89, 115, 116.) There was not a great deal of loss by spoilage. (R. 101.)

The Company was voluntarily liquidated on April 29, 1944. (R. 12, 38.) At that time, and for some time prior to that date, it had a contract with the Federal Government for the storage of various products, (R. 41, 93.) These products, which at the date of liquidation were valued at between two and three millions of dollars (R. 41), were stored under a contract which specified a monthly storage charge (R. 17, 94, 118). At April 29, 1944, the storage charges earned upon the government products stored at the Company's warehouse amounted to $37,225.96. (R. 117.) No part of this amount was included in income in the Company's return for the period ended April 29, 1944, the date of its liquidation (R. 117, 121), but this amount was shown as the value of the government's storage account for purposes of liquidation of the Company (R. 117, 118-119, 120, 128). The products stored for the government ordinarily would remain in the Company's warehouse from one to six months, awaiting ships for loading and transshipment (R. 58, 129) and that in storage at April 29, 1944, was only that which had not been removed because of no means of transshipment (R. 58).

The Commissioner of Internal Revenue concluded under these facts that the return filed for the period ended April 29, 1944, did not truly reflect the Company's income for that period and accordingly included the amount of $37,225.96 as a part of the latter's taxable income. (R. 13.) In this suit brought by the taxpayer and his associate stockholders, transferees of the assets of the Company, the District Court held (R. 17) that the inclusion of this amount, as required by the Commissioner, more truly reflected the Company's income because "the contract provides that storage shall be computed on a monthly basis" and rendered judgment on this issue for the United States (R. 18-19). From that decision the taxpayer has appealed. (R. 22.)

SUMMARY OF ARGUMENT

The taxpayer concedes that the Commissioner may require a different method of accounting in order that income may be clearly reflected. In the light of the applicable statutory provision that means that the Commissioner was within his province in requiring the Company to report receipts and profits in a manner which would clearly reflect income for the period involved. It is of no avail then to rely upon acceptance of the method of reporting prior to that period or to insist that the Commissioner could not change that method. By placing in gross income for the taxable period ended April 29, 1944, the storage charges of $37,225.96 which had actually accrued during that period the Commissioner, far from repudiating the fundamental basis or method upon which the Company computed its income, merely applied that method, i.e., the accrual, to all items of income and expense. It is the event of dissolution which caused the Commissioner to include the storage charges in the Company's income for the period up to the date of its dissolution and it is that event which gives rise to this case.

The law is well fixed in circumstances paralleling and on all fours with those in the instant case that when returns are made upon the accrual basis there need be only reasonable accuracy in calculating amounts to be accrued as income and that a taxpayer is bound to accrue in a certain year those items with respect to which there is justification for reasonable expectancy of payment in due course. Where a corporation, upon a completed contract basis of reporting income, dissolves and transfers its assets and liabilities to its stockholders, who continue and complete the contracts, it puts itself in a position where it can never complete its contracts. But that does not absolve it from its income tax liability and under those circumstances the Commissioner has authority to allocate to it income earned by it prior to dissolution.

In this case the Company put itself in the position of never completing its contract of storage entered into prior to its dissolution and the Commissioner was, therefore, entirely correct and acting within statutory authority in including storage charges earned prior to the date of dissolution in the Company's income. This was especially true because all events had taken place prior to that date to fix the amount and there was more than reasonable expectancy of converting that amount into money.

ARGUMENT

THE COMMISSIONER OF INTERNAL REVENUE CORRECTLY INCLUDED EARNED STORAGE CHARGES UP TO APRIL 29, 1944, IN THE GROSS INCOME OF THE WASHINGTON FRUIT AND PRODUCE COMPANY WHICH WAS LIQUIDATED ON THAT DATE.

The taxpayer concedes here (Br. 18) that the Commissioner may require a different method of accounting where the method used by the taxpayer does not clearly reflect income. This concession, of course, rests upon the provisions of Section 41 of the Internal Revenue Code, *supra,* which requires that "if the method employed [by the Company] does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income." As the Supreme Court stated in *Brown v. Helvering,* 291 U.S. 193, 203:

> Moreover, the method employed by the taxpayer is never conclusive. If in the opinion of the Commissioner it does not clearly reflect the income, "the computation shall be made upon such basis and in such manner," as will, in his opinion, do so. *United States v. Anderson,* 269 U.S. 422, 439; *Lucas v. American Code Co.,* 280 U.S. 445, 449; *Lucas v. Ox Fibre Brush Co.,* 281 U.S. 115, 120; compare *Williamsport Wire Rope Co. v. United States,* 277 U.S. 551; *Lucas v. Structural Steel Co.,* 281 U.S. 264. In assessing the deficiencies, the Commissioner required in effect that the taxpayer continue to follow the method of accounting which had been in use prior to the change made in 1923. To so require was within his administrative discretion; compare *Bent v. Commissioner,* 56 F. (2d) 99.

In *Carver v. Commissioner,* 173 F. 2d 29 (C.A. 6th), the court held that the fact that in previous years the Commissioner had accepted returns upon a basis other than that required in the taxable period involved will not preclude him from insisting upon a method which will clearly reflect the income for the period being audited. *William Hardy, Inc. v. Commissioner*, 82 F. 2d 249-250 (C.A. 2d), states the same rule.

In the light of this situation it is apparent that the taxpayer's argument (Br. 12-15) relating to the method which was accepted in prior years, and the authorities there cited, are of no avail to him here. Nor is there any merit in his urging (Br. 17-19) that the Commissioner has no right to change the method of accounting for the taxable period for the alleged reason that the method already employed by the Company clearly reflected its true income. The fact is that the method used by the Company for the period involved did not clearly reflect income, and this in effect was the Commissioner's finding (sustained by the District Court) when he required the inclusion in taxable income of the $37,225.96 in question.

In the normal operation of the Company's business in years prior to the fiscal year here in question earned storage charges were reported as income upon the removal of stored goods which usually took place before the close of the Company's fiscal year. As a matter of fact it appears from the record in this case that the fiscal year ending June 30 had been adopted for reporting purposes simply because that situation existed. (R. 45-46, 88, 115.) But regardless of how clearly the method employed by the Company with respect to reporting earned storage charges in the prior normal operating years might have reflected true income, it is apparent that such method failed to clearly reflect income in the year of the Company's liquidation which took place on April 29, 1944.

There is, therefore, no point in urging (Br. 15-17) that the liquidation of the Company did not enter into or effect the Company's tax situation for the period involved. It is the fact that liquidation took place and that it ended the taxable period at April 29, 1944, which raises the question of whether income is clearly reflected under the method used. The Commissioner, in the exercise of the broad discretion given him by Section 41 (See *William Hardy, Inc. v. Commissioner, supra*, p. 250, and cases there cited), has determined that in the light of that fact income is not clearly reflected if the liquidation's effect upon the method of reporting used is not taken into consideration. The taxpayer's position is tantamount to an insistence that that fact should be completely ignored without regard to the Commissioner's authority and duty under the applicable statute. That position is untenable.

The record here shows that the Company kept its books (R. 44) and rendered its income tax returns (R. 124) upon the accrual basis of accounting in the prior fiscal years (R. 45, 88, 115). It generally accrued expenses incident to the operation of its business (R. 61, 65, 121, 133) but storage charges collectible by it were not included in income until paid (R. 59, 65-66). By placing in gross income for the taxable period ended April 29, 1944, the storage charges of $37,225.96 which had actually accrued during that period, the Commissioner, far from repudiating the fundamental basis or method upon which the Company computed its income, merely applied that method, i.e., the accrual, to all items of income and expense. It is impossible for the taxpayer, especially in view of the liquidation of the Company on April 29, 1944, to show that the Commissioner's determination did not clearly reflect income or that it was in any way erroneous.

As we have pointed out, the law is well settled that the method employed by the taxpayer is never conclusive, and that if, in the opinion of the Commissioner, it does not clearly reflect income he may compute income upon that basis and in that manner which will, in his opinion, do so. *Brown v. Helvering,* 291 U.S. 193, 203. Moreover, it is equally well settled that "Keeping accounts and making returns on the accrual basis, as distinguished from the cash basis, import that it is the *right* to receive and not the actual receipt which determines the inclusion of the amount in gross income. When the right to receive an amount becomes fixed, the right accrues." *Spring City Co. v. Commissioner,* 292 U.S. 182, 184-185. These rules are not altered by the fact that a completed-contract method of accounting is used by a taxpayer. *Jud Plumbing & Heating v. Commissioner, supra.*

We have found two cases which are directly in point in support of the action taken by the Commissioner in this case. One of them, *Franklin County Distilling Co. v. Commissioner,* 125 F. (2d) 800 (C.A. 6th), parallels this case and the other, *Jud Plumbing & Heating v. Commissioner,* 153 F. 2d 681 (C.A. 5th), is on all fours with it. In the *Franklin Distilling Co.* case, *supra,* the taxpayer, which kept its books and rendered its returns upon the accrual basis, sought to exclude from the sales price of whiskey sold in 1935 the amount of production taxes paid by it upon its manufacture, which taxes were reimbursable to it in contracts of sales made in that year. The taxpayer moreover sought refund of taxes paid on the ground that storage charges accrued as income in 1935 should not have been so accrued because they were not collectible until the whiskey sold was withdrawn from storage.

In that case, with respect to the exclusions from 1935 sales prices, as in the instant case with respect to the accrual of storage charges, the taxpayer contended that its reporting was proper and should be sustained because (1) the reimbursement of production taxes it paid was not actually made to it in 1935; (2) the right to the receipt thereof was conditional; (3) the amount was unliquidated, being conditioned upon future events; and (4) that there was a reasonable probability that a large part of the amount would never be paid by the purchasers of the whiskey. The court, denying all of the contentions of the taxpayer, affirmed the decision of the Tax Court upholding the action of the Commissioner in including the reimbursable taxes in gross income for 1935.

In the course of its opinion in that case the court said (p. 803) that where income tax returns are made by the taxpayer on an accrual basis, there need not be certainty, but only reasonable accuracy, in calculating an amount to be received, in order to bring that amout within taxable income. It also said (p. 804) that whether a taxpayer is entitled to or bound to accrue an item of income in a certain year depends upon whether there was justification for a reasonable expectation that payment of the item would be made in due course. After citing the rule of *Spring City Co. v. Commissioner, supra,* from which the taxpayer here quotes (Br. 16), the court added (p. 804) that when accounts are kept on an accrual basis, income must be accounted for in the year in which realized, although not then actually received. Underscoring the words in Section 41 vesting broad discretion in the Commissioner, the court held (p. 804):

> Inasmuch as the accrual method of accounting adopted by the taxpayer was not "regularly employed," in that the accrued items of production tax payments passed along for assumption by purchasers of the whiskey sold during 1935 were not included in petitioner's income tax return, the Commissioner of Internal Revenue was clearly privileged to make his computation according to such method as in his opinion would clearly reflect the income. The petitioner has no legal basis for its opposition to such procedure.

In its decision the court dismissed the contention of the taxpayer that a refund of taxes paid was due because gross income had included storage charges which were not actually collectible in 1935 with the statement (p. 805) that there was no merit in the argument. Under the rule of *Spring City Co. v. Commissioner, supra; Brown v. Helvering, supra,* and other cases cited in its opinion, it held that the storage charge items clearly constituted income during 1935 and were properly included as such in the Commissioner's computation.

The court in that case reached its conclusions with full consideration of other cited cases, some of which are here relied upon by the taxpayer in the instant case, and it found no conflict with its views and the rule of those cases. It said specifically that there could be no quarrel with *H. Liebes & Co. v. Commissioner,* 90 F. 2d 932 (C.A. 9th), strongly relied upon by the taxpayer in the instant case (Br. 16-17), which laid down the rule that income accrues where there is an unconditional right to receive an amount and there is a reasonable expectancy of converting the right into money. In that connection, the court said (p. 805):

> The non sequitur in petitioner's argument flows from the fact that the record here discloses that petitioner has even more than a reasonable expectancy of converting its fixed right into money.

The same statement may be made in the instant case with respect to the storage charges, amounting at April 29, 1944, to more than $37,000. They were aggregated by the application of a fixed rate per month (R. 17, 81), so that the total at the end of any period was readily ascertainable, and there was "more than a reasonable expectancy of converting" the right to collect those charges into money, especially since it was a contract with the Government for the temporary storage of commodities needed in its then effort to win a war. This fact points up even more that when the Company here was liquidated and filed its return for the period ended April 29, 1944, it was not, in the same manner and extent as the taxpayer in the *Franklin Distilling Co.* case, *supra,* p. 804, following a method of reporting income "regularly employed" by it for it reported *no* income on account of the storage charges it had a right to receive.

The case of *Jud Plumbing & Heating v. Commissioner, supra,* as has been said, is on all fours with the instant case. It was decided against the taxpayer on facts almost identical to those in this case. There a taxpayer on a "completed contract" basis of accounting and reporting income, which in prior years had been satisfactory to the Commissioner of Internal Revenue, was dissolved in 1941 and its assets were transferred to its principal stockholder who continued and completed without interruption contracts which had been begun before its dissolution. That is the exact factual situation in the instant case. In that case none of the profits on the contracts completed subsequent to dissolution were reported as income of the corporation on the ground that under the method of reporting used by it and approved by the Commissioner the corporation was not required to include unrealized and undetermined profits because it had received no profits and had no income to report at dissolution.

In deciding the case, upholding the inclusion by the Commissioner of over $32,000 as the corporation's income for 1941 which had accrued to it out of contracts commenced before dissolution, the amount being computed on a percentage basis, rather than, as in the instant case, at a specified monthly rate, the court pointed out (p. 683) that the Commissioner did not reject the completed-contract method of accounting which had previously been followed by the corporation. It said, as effectively it may be said in the instant case, that under the facts in the case, that method of accounting did not reflect the income of the corporation up to the date of its dissolution. There, as here, the action of the Commissioner was taken under Section 41 of the Internal Revenue Code.

The court in that case said (p. 683) that the question before it was whether, under the completed-contract method of accounting, the corporation was liable for taxes on income, earned during the year of its dissolution, on long-term contracts entered into by it but completed by its successor after its dissolution and whether the Commissioner used an erroneous method under Section 41 of the Internal Revenue Code in allocating income for the year of dissolution between the corporation and its successor. That, it may be said, is the statement of the question in the instant case. Here, if the $37,225.96 item in controversy is not taxed to the Company during the period ended April 29, 1944, it goes untaxed altogether. Surely such a result would not clearly reflect the Company's income.

The whole of the opinion in the *Jud Plumbing* case, *supra,* is apt in the instant case but there are particular statements which read as if said in conjunction with this case. These are that a corporation, by a transfer of all of its assets and liabilities, cannot absolve itself from liability for income taxes due to the United States (p. 684) and that a corporation being a legal entity, its net earnings, whether ascertained or not, belong to it, and the tax upon unexempt income in each taxable year is chargeable to it (p. 684). The court added that that liability cannot be discharged by the simple expedient of dissolution, even though the corporation receives no money consideration in that act. It also said (p. 684):

> A taxpayer has the option of reporting his income on either a cash, accrual, or completion-of-contract basis if the method selected clearly reflects his income. But where a corporation: (a) carries on a business for two-thirds of the taxable year; (b) thereupon dissolves; (c) assigns and transfers all of its assets and liabilities to its chief stockholder; and (d) makes no return of its income; an annual return made by the corporation's chief stockholder and his wife, on the community basis, wherein they charge themselves with the net profits that they and the Corporation had earned during the tax year, could not be said to be a method of accounting as would clearly reflect income of the Corporation.

The court went on to point out (p. 685) that if the corporation's income was not returned in a manner which would clearly reflect its income, the return need not be accepted by the Commissioner, regardless of the method of accounting used, and that the

Commissioner has definite statutory authority under Sections 41 and 42 of the Internal Revenue Code, *supra,* not only to reject the method but to require the use of a method which does clearly reflect income. It added that a corporation (p. 685)—

> cannot avoid taxes by the simple expedient of not completing its contracts; and where a corporation puts itself in such position that it could never complete its contracts, it is in no position to insist that even if it had income it has no tax liability, or that its tax liability can be measured only by completed contracts.

We submit that it is perfectly clear, according to the facts in the instant case, that the Washington Fruit and Produce Company cannot escape its liability for taxes upon the storage charges earned by it, under the Government storage contract, or otherwise, prior to its dissolution, and that the taxpayer here and his associate stockholders are liable as transferees for the satisfaction of that tax liability. Here, as in the *Jud Plumbing* case, *supra,* the Company, through its very stockholders who now contest its liability, put itself in a position where it could never complete its contracts and it, too, is in no position to insist that it thus had no income and tax liability arising therefrom. On the same basis and grounds upon which the cases of *Franklin County Distilling Co. v. Commissioner,* 125 F. (2d) 800 (C.A. 6th), and *Jud Plumbing & Heating v. Commissioner,* 153 F. (2d) 681 (C.A. 5th), were decided against the taxpayer, we submit that the decision of the court below on the accrual of income issue in the instant case should be affirmed. See also, *Shelley v. Commissioner,* 2 T. C. 62; *Carter v. Commissioner,* 9 T. C. 364, affirmed on another issue, 170 F. 2d 911 (C.A. 2nd), and *Standard Paving Co. v. Commissioner,* 13 T. C. 425.

This position does no violence to the rule of this Court in *H. Liebes & Co. v. Commissioner*, 90 F. 2d 932. There it was said, as pointed out above, that income must be accrued, whether received or not, if there is a fixed or unconditional right to receive it and a reasonable expectancy that the right will be converted into money or its equivalent. That rule in fact comports with the cases upon which we rely and it compels the conclusion we urge because in the instant case, at the date of dissolution, all the events establishing the storage charges as income of the Company had taken place. The specified number of months at which the Government's goods were stored at a specified rate under a contract were ended and that created a fixed and unconditional right in the Company to recover a readily computable amount of money. The conversion of that certain right into money or its equivalent seems beyond question despite the fact that the goods had not then been removed from the Company's warehouse. The record here does not show whether any demand was made by the Company for the storage charge up to the date of dissolution, but whether or not such demands were made the Company had the same or equally as good reasons at that time for believing it had "reasonable expectancy" that the conversion into money would be made by the Government as did the taxpayer in the case of *H. Liebes & Co., supra,* that his court judgment would be converted into money.

Here, as in the *Franklin Distilling Co.* case, *supra,* as we have said, the Company had even more than a reasonable expectancy of converting its fixed right into money.

CONCLUSION

On the basis of the foregoing, we submit that the decision of the District Court on the storage charges accrual issue should be affirmed.

Respectfully submitted,

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